COLLECTIVE insight

insights into SA investing from leading investment professionals

economics and investing

Just how connected are they?

Please email feedback and suggestions to:
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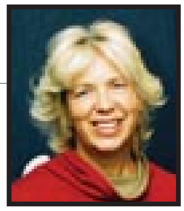
From the Advisory Committee



BY ANNE CABOT-ALLETZHAUSER
m Cubed Asset Management

SOME months ago, m Cubed Asset Management, in conjunction with *Finance Week*, identified a clear gap in the market to introduce an investment journal that would showcase the best research currently being done on asset management and consulting in the South African market.

The publication's objective is to collate research papers from the academic sphere and asset management industry in a way that would integrate fundamental investment principles with best practice reality and cutting-edge thinking.

The format should be equally accessible to casual readers and to investors who may already have significant knowledge about asset management. It should provide a forum through which ideas can be introduced, interrogated and, if necessary, challenged.

Therefore, the trick was to create a journal that SA's broader investment community and its stakeholders could collectively "own", carrying content totally independent of commercial interests.

To that end it was proposed that financing the journal would be made through sponsorship and advertising, allowing small and large players to participate in equal measure. We're particularly grateful to the many contributors who elected to financially "take the plunge" with us without any advance knowledge regarding the project's outcome. A list of sponsors and advertisers appears alongside.

Further, it was proposed that the thematic focus, content and future direction of the journal should be overseen by a rotating Advisory Committee representing independent members of SA's broader academic, investment and consulting industry. To further ensure autonomy, selection of reports or representation on the Committee would in no way be related to sponsorship of the initiative.

The response to the overall concept has been enormously encouraging. More than 45 financial and academic institutions have shown an interest in participating at either the sponsorship level, the writing level or the Advisory Committee level.

Understanding the concept

Each issue of *Collective Wisdom* will represent a collection of articles around a central theme – in the first issue's case, "Economics and investing: Just how connected are they?"

The key will be to find that delicate balance between theory (explaining how things are supposed to work) and the practical reality (what does the practitioner really experience in the SA context). The focus is first and foremost on the South African experience.

Though each report should help the reader develop a fundamental insight into the underpinning theories, it should equally help readers understand the broader debate regarding these theories.

Putting together our first issue

More than 22 articles were submitted for this first issue, presenting the Advisory Committee with its first substantial challenge. To ensure that reports were selected on merit alone, all author and company names were removed from the articles before they were sent to Committee members for evaluation.

After the Committee members made their own individual assessments of each article, the Advisory Committee met and debated the merits of each article in detail. Any editing of articles was done as a collaborative effort between a Committee member and the author.

We believe that the six articles selected for this first issue of *Collective Wisdom* represents a well-diversified introduction to the complex issue of: "Economics and investing: Just how connected are they?" The intent is to show how diverse the view on this topic can be. The Advisory Committee does not endorse the content, which does not necessarily reflect its views or opinions.

We look forward to hearing your thoughts and comments on our efforts. ■

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Beauty parades, betting and bubbles

Trying to make sense of the markets

BY DEON GOUWS
Sanlam Multi-Manager International

PERHAPS Winston Churchill summed it up best when he said that he couldn't get his mind around economics – but he knew that shooting Montagu Norman would be a good thing. At the time Norman was the Governor of the Bank of England and, therefore, one of the most influential economists of his generation.

At one level it seems obvious that there must be a strong connection between economics and investing. After all, if this were not the case why are there so many economists who are gainfully employed in the investments industry? Is it not true that investing simply boils down to a call on the future fortunes of businesses, as well as the economics of the industries and the regions within which they operate?

Human beings suffer from greed and fear and sometimes get caught up in the hysteria of crowds.

Some market participants will indeed subscribe to such a theory. However, there are many others (such as Churchill) who will no doubt beg to differ. Perhaps that's why economist jokes abound within the world of investments. In the words of Peter Lynch, the celebrated portfolio manager who ran the Fidelity Magellan Fund up until his retirement at the tender age of 46 in 1990: "If all the economists of the world were laid end to end it wouldn't be a bad thing."

If there was one economist who did more damage to the reputation of his profession than any other from the point of view of the investment world it was probably Irving Fisher. This renowned monetarist is remembered for explaining the cause of inflation by developing the elegant Fisher Equation of Exchange.

Unfortunately, his credibility suffered when, a few months before the crash of 1929, he was famously quoted as saying that stock prices have reached "a permanently high plateau". Worse still, he tried to defend this position in subsequent years, insisting throughout the Great Depression that recovery was imminent.

John Maynard Keynes was a contemporary of both Fisher and Norman. Would his endurance as an economist (his insights are taught at universities and followed by governments to this day) have anything to do with the fact that he undoubtedly also had a better understanding of the vagaries of the market than most of his peers?

For example, it was Keynes who came up with the immortal quote: "Markets can remain irrational longer than you can remain solvent." Fisher should have taken heed!

It was also Keynes who likened professional investment to competitions in which newspaper readers have to pick the prettiest faces from a number of photographs, the winner being the one whose choice most accurately reflects the average preference of all competitors.

As Keynes said in his seminal work *The General Theory of Employment, Interest and Money*: "... each competitor has to pick, not the faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view.

"It is not a case of choosing those which, to the best of one's judgement, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree, where we devote our intelligences to anticipating what average opinion expects average opinion to be."

This famous analogy can be considered a forerunner of the field of behavioural finance, popularised by Daniel Kahneman and Amos Tversky half a century later (Kahneman won the Nobel Prize for Economics for his work in this field in 2002).

Put simply, the principles of behavioural finance hold that investors in the stock market will often make decisions that are not grounded in economic principles. The reason for this is simple: market participants are human beings and, as such, their actions are influenced as much by emotions as they are by reason.

Behavioural finance stands in stark contrast to the efficient market hypothesis (EMH) developed in the sixties by Eugene Fama. In terms of this theory, a discounting process determines stock prices – such that they equal the present value of expected future cash flows. Based on this, stock prices reflect all information and are, therefore, supposedly "accurate" at all times.

The EMH is based on a number of simplifying assumptions: most notably, that all market participants are rational, profit-maximising individuals. And it is this very notion that is attacked by the behaviourists.

After all, human beings are *normal* rather than rational: they suffer from greed and fear and they sometimes get caught up in the hysteria of crowds. As a consequence, stocks will often be badly mispriced. Moreover, such overpricing or underpricing can indeed prevail for extended periods of time – resulting in an apparent breakdown in the link between economics and investing.

However, any reference to the mispricing of stocks is based on the assumption that a certain specific price level exists that can indeed be considered to be valid or accurate or fair. What would such a value be and how would it best be formulated?

For example, some people might say that a certain price:earnings ratio is "fair" for a certain stock in question, whilst others – believing in a more optimistically minded, growth-orientated approach to investing – might be prepared to pay up significantly for the same share.

Yet a third group may contend that the p:e ratio is not even a valid measure to begin with, preferring to focus on cash flows or some other measure of economic success. Such is the nature of a market.

This point goes to the very heart of economics: namely, the existence of markets as clearing mechanisms. In terms of first principles, and in the

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3 parlance of Adam Smith, the price of a product will be set by the "invisible hand" of the market at a level that ensures an equilibrium between supply and demand. In this case, reference to a "correct" price does indeed appear to be justified.

However, shares are not the same as goods, since shares are not consumed. A share transaction has more in common with a bet between two punters: where one believes that the price is likely to increase (or "outperform"), with the other taking the opposite view. In terms of this betting analogy, the share price merely acts as the odds on which they agree.

This may explain why equity markets are more volatile than the markets for most goods and services, where basic economic principles may appear to prevail to a greater extent. Stock markets are influenced by a near-infinite number of factors and many of these are probably not even considered (or well understood) by the vast numbers of participants.

These participants come from different parts of the world, they have very different cultural backgrounds and patterns of behaviour, they trade in different time zones and they do so for a plethora of different reasons. At the same time they all continue trying to second-guess one another (in a Keynesian, beauty contest kind of way) while forecasting nearly everything else that might or might not happen in the world.

John Maynard Keynes... markets can remain irrational longer than you can remain solvent.

Does all of this mean that there's no direct link between investing and economics, between the price of a share and its "real" value? No. It merely highlights the fact that the relationship between the two is not a simple, deterministic one.

In the same way that "par" suggests the most likely score when a professional plays any golf hole, the underlying economic fundamentals of a company form a basis for forecasting share price action. It's true that share prices exhibit tremendous volatility – but then so does the performance of golfers, who score considerably better than par during certain rounds of golf and much worse in others.

No discussion of the link between investing and economics can be complete without at least a brief reference to the theory of reflexivity, as explained by George Soros in *The Alchemy of Finance*. In simplistic terms, Soros contends that economic reality does not only influence market prices but that the relationship simultaneously also works in the opposite direction – ie, markets can in fact influence the events that they anticipate (which explains why markets may so often appear to anticipate events "correctly").

The market is always right in what it does but not always when.

To mention but one example: cast your mind back to the height of the Internet bubble, a short four years ago. At that time the stocks of companies in the technology sector were trading at exorbitant prices – simply because the

Winston Churchill... at loggerheads with economists.

majority of stock market participants seemed to agree that there was suddenly a different reality at work in the world and that most of these companies would succeed in a new economy.

Companies without any track record (and, with the benefit of hindsight, often even with dubious business plans) were therefore not only allowed to list successfully; in many cases they actually attracted huge amounts of capital that would "normally" not be justified. However, this capital allowed many of them to actually develop viable products and services, even if this happened some time after the listing – clearly a reflexive situation where stock market behaviour had a constructive impact on the underlying economics of an industry (rather than the other way around).

Of course, the technology bubble did not last – once again proving the old saying that the market is always right in *what* it does but not always *when*. Another way of saying this is that, in the longer term, the fluctuations in the investment markets will ultimately reflect underlying economic reality. Unfortunately – to quote John Maynard Keynes one final time – in the long run we'll all be dead. ■

Economics and investing

Be aware of economic cycles, just as you watch the changing seasons

BY ADAM EBRAHIM
Oasis Asset Management

THE underlying common thread that runs between economics and investing is that both of these "systems" describe an entire spectrum of choices. In its theoretical proposition, the theme of economics fundamentally explores the choices that are related to the scarcity of resources and the supply and demand of these resources, while investment essentially represents a "microcosm" of economic theory, in that it also revolves around the basic supply and demand notion.

The expedient words of the famous economist John Maynard Keynes serve to introduce the link between the turbulent worlds of economics and investment: "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation."

The pertinence of this quote lies in its potential interpretation: I would interpret the notion of a "steady stream of enterprise" to be symbolic of solid economic functioning (ie, the theme of economics) and the "speculation" component may represent what clearly distinguishes the theme of investing from economics: the nature of investment and stock markets in perhaps their most stereotyped form.

Keynes was wise in his foresight, because what this quote essentially alludes to is the potential for one system to burden the other, should it inflate to proportions that we saw at the turn of this century – the short-lived reign of the tech bubble. This interesting event in the world's economies and markets offers an interesting case study to explore the relationship between economics and investing.

The themes are deeply and inextricably intertwined. This is indisputable. The theory of economics may encapsulate the process of investing, yet investing holds an implicit forward-looking, forecasting component that in essence incorporates critical cognisance of the role of economic variables.

Ultimately, the two themes do operate as two distinct systems by virtue of their definitional boundaries, yet one is actually a sub-system of the other (investment is a sub-system of economics by theoretical proposition – ie, it's a component of economic functioning).

In contrast, if one views the absurdity of these two systems operating in isolation the inextricable link is reinforced. Can the markets/process of investing truly operate in isolation from the broader economic environment? In a hypothetical, ideal, simplified and separated world we could invest in securities that will create value independently of economic cycles and the governing fiscal and monetary climate.

> **"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation."**
> ***- John Maynard Keynes***

Companies that are invested in perform in isolation: they're generating returns that are entirely unaffected by economic influences. This is taking place while large, underlying macroeconomic trends are fundamentally moving and shifting with no impact whatsoever on the movements of the markets.

Hypothetically, yes. However, in our real and complicated world, never. It's entirely impossible to separate the two themes. Not only because investment in its purest form is in essence an *economic* transaction, but also by the very critical impact that economic variables and the broader economic climate have on market performance in its entirety, and vice versa.

The very removal of trade barriers and exchange controls is in itself a manifestation of economic policy: the impact of this on investing has indeed been pivotal in creating a framework in which markets have become much more sensitive and vulnerable to broader economic themes.

So what are the key variables? Economic growth and output (GDP, GNP and related income measures), inflation, policy instruments (such as interest rates and fiscal budgets), exchange rate movement and cyclical and secular shifts in economic climate all play a critical role in the psyche of any investor. We can say that economic factors affect the performance of markets – and thus determine how investors behave.

The direct link is through a flow of information that's received by the market, thus creating both speculative and arbitrage opportunities for those who are anticipating the impact of key economic variables on market behaviour and are then able to appropriately interpret these variables. The market thus receives the information, reacts and this movement then feeds back its reflection of the broader economic climate and pertinent variables at play.

For example, prior to an announcement of the latest inflation figures the market builds up an anticipation as to what will play out: on announcement, the market adjusts its consensus of this variable and realigns itself with the information received. In that passing moment, opportunities to create wealth and to speculate with various market instruments may exist.

Yet the market always reverts to some proxy of present available information at a point in time (as "efficient" as it may possibly be). It's highly unpredictable, often overreactive or underreactive, and closely related to psychological and behavioural processes of investors.

Warren Buffett's view of market efficiency is worth indulging in at this point. When asked if he feels that markets are truly efficient, his comment – "I'd be a bum in the street with a tin cup if the markets were efficient" – is indeed music to the ears of an active fund manager who seeks to outperform the market in the long run.

The direction of the relationship explored above places the role of economic variables as the catalyst for market movements and a powerful influence on the decision-making processes of investors. This certainly seems to be the dominating trend in the interplay between economic variables and investing; yet we've witnessed the onslaught of the tech boom ushering in new terminology, such as the "new economy".

That's a perfect demonstration of a deviation from the status quo that positions investing as a process that's always reactive to broad economic variables. The heightened investor irrationality that played out over this short period of market reign (late nineties to just after the turn of the century) created a situation where "enterprise became the bubble on a whirlpool of speculation" in the words of Keynes.

The greatest misperception of the quality of the technology sector between 1999 and 2001 was that it was believed to be a stable growth sector. Not only did investors hold the perception that the technology sector's earnings growth was stable, but the actual valuations given to technology stocks were extremely high because they incorporated assumptions regarding both exceptional growth combined with exceptional stability of growth.

If there was going to be a so-called "new economy" (a term used to describe a mythical economy that's characterised by no cycles, in which the technology, media and telecommunications are the only sectors whose earnings grow) then to justify their decisions, investors must have truly believed that this "new economy" would not have the normal cycles that have characterised every other economy in world history over time.

We seldom heard about the role of key economic variables over this period: the dominant climate was a global bull run that created immense hype and culminated in the overextension of balance sheets, the spread of corruption and greed and unsustainable "growth" that led to the rapid collapse of stable, fundamental economic functioning.

In actual fact, at the start of this illustrious bubble much of the world was in recession and technology sector earnings were also hurt by the significant slowdown in global growth. It was largely hype and a herd mentality that led investors to believe that the tech sector was a high quality, stable growth sector when in fact it was a cyclical, slower growth sector.

Key economic variables did *not* govern this investment process. The market disrupted the economy. The roles were reversed and the effect was severe.

Today, global economies are still contending with the after effects of the pathological and irrational investor psyche that drove the bubble impulse and is largely the protagonist for the current depressed global economic environment. Post-hysteria, the role of fundamental value is re-emerging, as the rampant market becomes subdued again and governing economic variables resume centre stage in the investment process.

Indeed, there's a lesson to be learnt here. By analysing the interaction between the theme of investing and the theme of economics through the exploration of the direction of the relationship and the illustration highlighted above, where convention is turned around, we're reminded of the pertinent role of economic variables in investment.

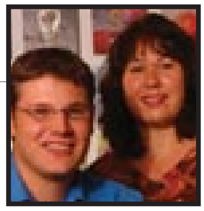
Be aware of economic cycles, just as you watch the changing seasons. Each type of investment has its cycle, and the way to invest safely and profitably is to keep in harmony with these cycles.
- Leon Richardson

The discourse addresses the necessity of contextualising investment within the broader economic climate: the two systems can not operate independently of each other and the sub-system clearly should not hi-jack the governing system.

Rather the optimal scenario is an ongoing, gentle interaction that seeks to continuously remain critically informed of the vital driving forces that are dictating the movement in both the themes of economics and investment at any point in time.

The economy ultimately sets the stage for the markets to perform. ■

A trustee's guide to adding value



Thinking differently about economics and investing

BY SONJA SAUNDERSON &
JD VAN HEERDEN
m Cubed Asset Management

HAS SA's investment industry gone terribly wrong with trustee education? Just what do the trustees of billions of rand of retirement fund assets understand about economics and investing and how is that knowledge applied?

Trustees spend any number of hours each year listening to the managers of their assets go into elaborate explanations of economic change – past, present *and* future. But to what end? Like the widespread misuse of performance survey rankings as a basis to hire and fire managers, presentations of economic insights often provide trustees with an unfounded sense of comfort in a manager's ability to correctly steer a fund into the future. Given the wealth of academic literature that highlights just how weak the link is between forecasts of economic change and correct anticipation of market movement, this may be a misplaced faith.

Ironically, though, it's the trustee and not the fund manager who has the greatest *potential* power to determine how well their fund weathers future economic environments. However, unless trustees understand how they can wield that power to best effect, future performance will always be dependent on such low probability/high cost investment decisions as economic forecasting and market timing.

It's the trustee and not the fund manager who has the greatest *potential* power.

This takes us back to the issue of education. David Salem, CEO of the Investment Fund for Foundations, summarises the dilemma perfectly in an article on setting investment policy, when he says that dozens of trustee training manuals explain to trustees *what* a stock or a bond is but not *why* an investor should invest in these different classes. The key to setting meaningful investment policy asset allocations is in understanding how different asset classes respond *in general* to different economic environments.

For example, a mature fund concerned with issues of inflation should appreciate that property or resources shares generally provide a good hedge to inflation. As such, this insight could help inform the asset allocation composition of the fund or the benchmark the fund elects to use.

A fund comprised of predominantly young members may have a greater concern with deflation. Typically, we think of young funds as having high equity exposures but in fact, if deflation is a concern, both SA bonds and foreign assets provide some hedging benefits.

Here is where training of trustees needs to make a crucial advance. The greatest responsibility that trustees hold is in ensuring that the funds under their stewardship are robust to the economic environments that might have the greatest effect on their specific member profile.

For trustees to successfully meet these responsibilities two developments need to occur. First, trustees need to shift their thinking from "which blend of assets provides the highest return for the level of risk the fund is prepared to assume" to "which blend of assets provides the most robust solution for matching to the fund's future funding requirements, given the underlying member profile".

Second, because of the complex interplay of factors in the unfolding of any economic event the investment industry will need to provide trustees with more sophisticated, quantitatively driven tools to help them effectively calculate the sensitivity of their asset allocation decisions to different economic scenarios.

Let's use another common trustee dilemma to illustrate why such a tool is critical.

Recently, because of weak equity markets and the relatively high inflationary environment, there has been a surge of interest by trustees in products and portfolios designed to provide performance in line with inflation on a continuous basis. Now, as inflation rates continue to decline in SA's markets, what trustees really need to assess is what the effect of this change in the economy would be on such a product or portfolio.

Conventional wisdom may suggest that because inflation erodes purchasing power, the greater the risk of rising inflation the more investors in general sell out of bonds, which pay a fixed rate of interest (except for inflation-linked bonds). Investors buy into equities and other assets during such periods on the assumption that these assets outpace inflation. By investing more money into equities, demand rises – generally sending equity prices higher.

If we were experiencing exactly the opposite scenario, the lower the risk of rising inflation the more investors should be willing to invest in a less risky asset class, such as bonds, yielding a steady rate of interest, since the need for exceptional returns will have diminished – sending bond prices higher.

However, in reality trying to capture the effect of changing inflationary conditions on a fund requires a set of interrelated equations combined into a robust model describing the underlying dynamics that play a role in the economy. Often one event in the economy triggers other events and movements and they, in turn, trigger even more changes.

So the only real way that one can quantify the effect this will have on markets – and, eventually, a specific fund – will be to try and capture these movements in a logical framework using multifactor econometric modelling techniques.

Building a viable tool for trustees

We believe that an important starting point for creating such a tool lies in the very research and modelling techniques that have been developed over the past 20 years by quantitative asset managers in their efforts to translate changes in economic variable into forecasts of asset class movements.

Research, both in SA and internationally, by authors such as Henn and Smit (2002), Van der Merwe (1995), Barr and Kantor (2002), Smit and Van Rooyen (2002), Van Rensburg (1999), Cornelius (1991), Fama (1981), Schwert (1990) and Geske and Roll (1983), to name but a few, helped set out the basic framework for such modelling exercises.

One of the more important conclusions of these exercises is that the multifactor modelling framework, whether driven by economic factors or company-specific factors, has proved to be far more reliable as a tool for measuring risk or the sensitivity of portfolios than it has been for creating a return-forecasting tool.

Richard Thaler argues that at the root of some of the well-known paradoxes and anomalies in economic theory and modelling are human beings and their tendency to simply get things wrong.

Richard Thaler, in his book *The Winner's Curse*, helps explain why this is the case. He argues that at the root of some of the well-known paradoxes and anomalies in economic theory and modelling are human beings and their tendency to simply get things wrong – *bounded rationality*.

For example, the leading economic model of savings behaviour – called the life-cycle hypothesis – does not take account of arguably one of the most important human factors influencing savings decisions: namely, self-control. In this economic model if you have the unexpected good fortune of winning R100 000 you're expected to save almost all of it, since your goal will be to evenly distribute consumption of these winnings over the rest of your life. Clearly, this model doesn't take the shopping habits of the average South African woman into account!

We therefore recognise that even the most detailed and well-thought through modelling approach of the economy could never fully capture reality and give 100% accurate predictive ability. However, the same type of multifactor economic model has a particularly high level of explanatory power in terms of assessing a fund's robustness to changes in the economy; in other words, quantifying how sensitive your investment strategy will be to economic events, whenever they might occur.

In our research we set out to try and measure the effect of changes in SA's economy on different portfolios, consisting of different asset classes. Models were developed for SA equities, bonds and cash, resources, financials and industrials. (These asset classes will gradually be expanded to include an even broader range of asset classes.)

The independent economic variables were grouped under different headings, depicting the main forces driving the economy by means of a simplified principal component process (for example, inflation, interest rate, economic growth,

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9 monetary policy, fiscal policy, commodity prices, exchange rate and foreign markets).

The next step in trying to make sense of SA's economy and its implications on investment reality was to try and formulate some logical structure or model that can help us understand this relationship. (For a full copy of the paper, please e-mail ssaunderson@mcubed.co.za).

The ultimate result is a sensitivity tool that can be used by the end-user (eg, trustees) to test the sensitivity of a user-defined portfolio (ie, the user assigns different weights to the different asset classes, resulting in the desired portfolio) to expected movements in the economic variables. By using a sensitivity tool, the trustee is able to quantify what movements in portfolio performance can be expected under different economic scenarios. The trustee can describe different economic scenarios in terms of various economic factors, which in combination will sketch a specific macroeconomic picture.

The value of looking at the sensitivity of a fund to different economic scenarios is that it allows trustees to "stress-test" their fund structure and investment policy decisions.

Let's look at a concrete illustration. Assume that, as a trustee, you're trying to determine which of two balanced portfolio recommendations is the one most robust to changing inflationary environments. The two graphs give some of the output from the sensitivity tool that can help trustees determine an interpretation of the robustness of each fund to changing inflationary environments.

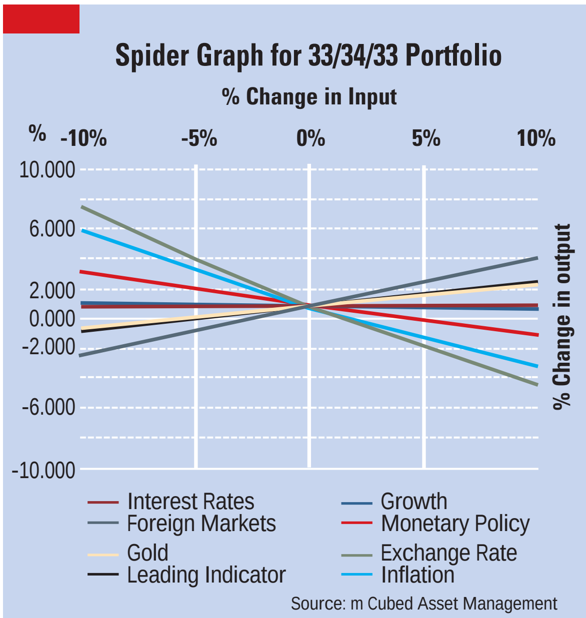
The first shows a spider graph for a typical balanced portfolio consisting of 33% equity, 34% bonds and 33% cash (33/34/33). The second shows a spider graph for a portfolio consisting of 75% equity, 20% bonds and 5% cash (75/20/5). The spider graph compares the effect of changes in the economic variables to changes in the portfolio performance.

For each input/economic variable, the percentage change in results is plotted on the X-axis and the accompanying percentage change in the output/portfolio variable is plotted on the Y-axis. The spider graph therefore gives the directional relationship between independent and dependent variables. The steeper a line on a graph, the more sensitive the fund is to that economic factor changing.

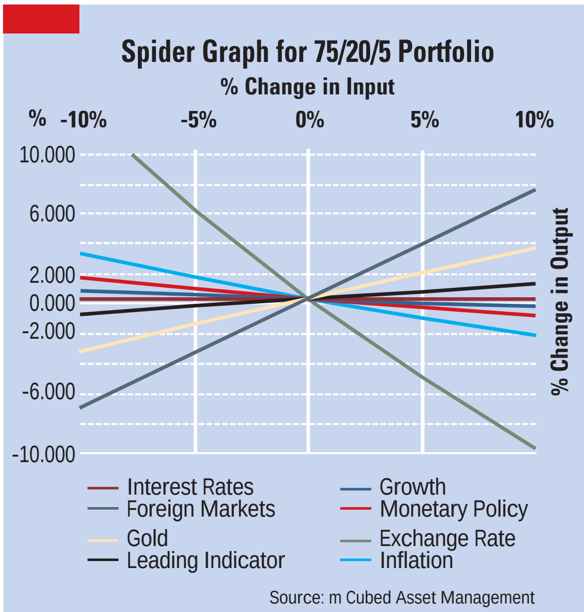
The purple dotted lines show that if inflation rates come down by 10%, the 33/34/33 portfolio is expected to increase fund performance by 6%, whereas in the 75/20/5 portfolio it's expected to only have a 3,5% increasing effect. If our only concern was maximising returns in an environment of declining inflation, then the 33/34/33 would be the obvious choice. But because of the higher sensitivity of this portfolio to any changes in inflation, it also means that the portfolio will be more adversely affected when inflation increases.

Therefore the real choice for trustees is to determine whether they want a portfolio that's less impacted by any variation in inflation (ie, robust to this economic scenario) or a portfolio that will benefit from a specific directional move in that factor. The fund's specific risk preference therefore plays a critical role in the issue of robustness and the choice of optimal portfolio.

Clearly, the value of looking at the sensitivity of a fund to different economic scenarios is that it allows trustees to "stress-test" their fund structure and investment policy decisions. More importantly, however, by providing trustees with a tool that they themselves can use to test different parameters and permutations one has genuinely provided them with the means to make more meaningful contributions where they're required – as trustees – to make contributions. ■



Source: m Cubed Asset Management



Source: m Cubed Asset Management

Peeking at gold

Assessing the portfolio utility of the metal and other assets

BY SYLVIO LEFEBVRE
Value Portfolio Managers

INVESTING in gold and gold shares has always been part of the South African investment landscape. One of the more emotional of investment themes, gold is currently back in vogue following a revival in the US dollar gold price and sharp outperformance of SA gold shares since early 2000.

Have favourable structural changes in the demand/supply equation occurred? Are the prospects for gold investment significantly better going forward or is this just a short-term opportunistic rally?

Traditionally, gold is regarded as a hedge against downturns in the stock market. If true, this counter-cyclical nature has attractive portfolio construction qualities and this is one of the positive arguments currently proposed to support gold.

However, gold has not displayed the sustainability and the consistency that this premise would suggest. Sadly, as an investment gold has not provided even satisfactory returns over the long term, with only three major peaks in 220 years.

The last great bull market occurred in the seventies, a period featuring historically high global rates of inflation. During this period it was natural to hold hard assets in a pursuit to protect wealth against the ravages of excess inflation and, consequently, the gold price rose an extraordinary 1 750%.

Conversely, because of the sharp increase in the cost of capital during this period, financial assets fared very poorly and the Dow Jones industrial index fell sharply in real terms while bond values nearly halved.

Because gold as an investment relies so much on supernormal returns over a few short bursts it's critical to ensure that a decision to buy gold shares for investment is aligned with appropriate long-term economic fundamentals. This brief report explores whether current economic conditions suggest investment in gold above other assets to protect and create wealth. If true, the recent strength in the price would point to a prolonged bull market. Otherwise, the recent run on the gold price and gold shares is opportunistic and best left to short-term traders and momentum investors.

Market players who favour gold highlight the structural changes on both the demand and supply sides. On the supply side, the more co-ordinated gold sales of central banks and the turnaround in forward selling by producers have certainly placed the industry in a stronger position, providing a better underpin to the gold price – bull or bear market.

The demand side is more difficult to gauge. Sentiment here is driven by external political, socioeconomic and market concerns. Factors such as increasing concern over the value of the US dollar and its future as a reserve currency, loose monetary policy, spiralling budget deficits, weak equity markets and risky bond markets have sparked renewed interest in currency plays, alternative investments and hard assets such as gold.

These factors tend to call attention to gold's perceived ability to thrive during periods of economic difficulty. To investors, many of the current economic concerns are similar to those prevailing in the seventies.

There exists sufficient economic uncertainty and market volatility to warrant investors' concern. However, the root of the current malaise must not be confused with the cost of capital and inflationary adjustments that took hold in the seventies.

A closer examination of longer economic conditions shows a vastly different economic environment ruling today, one characterised by deflationary pressures and adjustments leading from lack of demand and poor corporate profitability. Such conditions seriously question a prolonged bull market in gold.

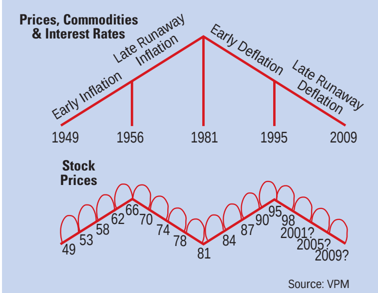
Current economic conditions have all the appearance of a real business (earnings) adjustment and, consequently, there's no imperative to own non-income-earning assets geared primarily to protect the erosion of wealth by inflation pressures. Such assets are more suited (almost a necessity) when the real value of financial assets is at threat from runaway increases in the price of goods and services, commodities and – most important – in the cost of money and capital.

It's broadly accepted that a combination of monetary factors (prices and interest rates) and real factors (economic and business performance) give rise to long-term bull and bear markets in the price of investment assets. However, few practitioners consider the alignment of portfolio asset exposures to long-term economic circumstances.

This application is supported by the behaviour of asset returns and economic conditions over the past approximately 50 years. During the fifties and sixties, SA and the rest of the world experienced sustained, consistent economic growth with strong real expansion in industrial and mining activity. Notwithstanding the expansion in economic activity, this period was characterised by only moderate pressure on prices of goods, commodities and interest rates.

This initial period – the "real" bull phase – of strong steady growth and only moderate increases in inflation and interest rates is particularly advantageous for equities producing above average real investment returns.

Study of prices confirms long economic cycles



The period that followed – the monetary bear phase – is best described by overextension of economic activity and capacity creation. The expansion of the seventies and early eighties put pressure on the supply of production factors and sharp increases in the price of labour, commodities and interest rates (cost of capital) created a backdrop of runaway inflation, which proved difficult for financial assets to sustain their value.

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11 The effect on investment markets was particularly pronounced. Equity returns were negative in real terms and bond values succumbed severely as bond yields rose sharply. The increase in the cost of capital placed tremendous pressure on price:earnings multiples. Share values fell meaningfully. Highly geared companies were particularly hard hit.

However, hard assets thrived on the high inflationary conditions. This presented a unique opportunity for investors to profit from a fundamentally well-founded positive price trend in precious metals, resources and other commodities. More specifically, this experience points to rampant inflation as a vital driver for a sustained bull market in gold.

As inflation accelerated in the seventies the cost of capital increased significantly. Interest rates struggling to keep pace with rampant inflation produced a final push towards real rates late in the cycle, finally putting a brake on excess inflation and setting the scene for a period of prolonged real interest rates.

Over the next two or three years bonds will become increasingly risky and equities will be progressively the more appropriate investment.

The period from the early eighties to late nineties – the monetary bull phase – was branded by deflationary adjustments favourable for financial assets. Prices of goods and services, commodities and interest rates all fell over this period. This process was the result of the significant rationalisation and corporate restructuring that took place to reduce the excess capacity created in the previous inflationary phase.

Cutbacks in capacity enhanced the return on assets and capital employed and contributed to corporate profitability meaningfully. Not surprising, therefore, this phase was accompanied by a strong bull market in equity prices, with investors reaping meaningful real returns.

Naturally, also, the more moderate demands on capital and monetary policy supporting real but lower rates were most beneficial for holding bonds. Other than due to shorter-term inventory pressures, commodities didn't prove an appropriate asset class.

This brings us to recent times. From an inflationary perspective conditions bear little resemblance to the seventies. Little threat of runaway inflation currently exists. This phase – the "real" bear phase – is the last in the cycle and extends on the deflationary adjustments of the previous period. Prices of goods and services, commodities and interest rates continue to fall but the limitations of demand now become widely evident. Workforce cutbacks, higher unemployment, the poor leverage of demand to interest rates and consequent sluggish corporate profitability are all realities. Interest rates reach historical lows and bonds continue to do well.

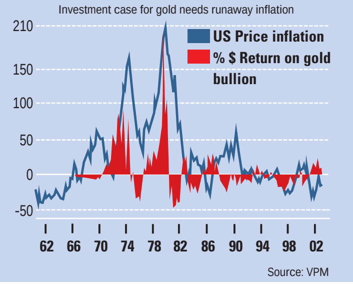
However, in spite of historically low cost of capital the performance of equities as an asset class is hampered by poor corporate profitability. The lack of clarity on corporate performance creates nervous and uncertain market conditions and equity returns are volatile and poor in absolute and relative terms. Price:earnings ratios become less predictable and, consequently, stock prices come under pressure from time to time producing good value propositions in equities.

Investors should be aware that we're entering the late stage of deflationary adjustments. Over the next two or three years bonds will become increasingly risky and equities will be progressively the more appropriate investment as the market anticipates the beginning of a new "real bull" phase of sound sustainable economic growth. This is expected to begin in the second half of this decade.

Strong real growth in global industrial production will benefit sectors and companies geared to economic recovery and, without excessive pressure on inflation, portfolio investment strategy will profit from high exposure to equities. In contrast, the expansion will lead to rising interest rates and any exposure to bonds will increase portfolio risk and dilute overall portfolio returns.

One of the possible catalysts for this new phase of economic growth is the economic potential of China, which represents a major proportion of the world's population. After having been constrained for so many years, China's economy has displayed rapid growth and consequently has influenced the

No likelihood of runaway inflation in the short term



demand and prices of commodities.

The question is whether the current pace of growth in China is sustainable and whether this can precipitate global production bottlenecks, leading to acute inflationary conditions similar to the Seventies. Given the size of the Chinese economy in world GDP, such pressure is unlikely. Rapid economic expansion in China will complement rather than destabilise the phase of early steady expansion over the next decade. Short-term inventory cycles will always provide opportunity for some to profit from short-term price volatility in commodities.

However, given the orderly nature of early long-term expansions and the small likelihood of runaway inflation the need for portfolio exposure to hard assets will remain low.

Gold is a special case of the hard asset proposition and though occasional technical factors can and do provide short spikes in the gold price, the environment for a sustained bull market in gold will not exist for some time.

In fact, fundamental norms of value indicate an exceptionally high risk of investing in gold shares. The overriding positive sentiment means one is not adequately compensated for risk. The dividend yield on SA's gold mining index is currently lower than that of the financial and industrial index. The p:e ratio is historically high and above the market average. Fair valuations of gold shares are on balance 50% to 60% of ruling market prices, while a more stable rand could be a further headwind to margins. Consequently, holding gold shares presents little margin for safety.

Nervous money always tends to see value in gold. Without building inflationary pressures and gold shares at more reasonable valuations gold bulls are likely to face disappointment. ■

Currency matters

But how? Determining a link

BY GREG ECKERSLEY
Alliance Capital Management

HISTORY is littered with lessons, often not learnt, on how economic cycles and general economic mismanagement have led to fortunes being made and lost by investors.

The South Sea Bubble (1720), the Mississippi Scheme (1720), the Great Crash (1929), the Lesser crashes of 1970 and 1992, the Asian Crisis of 1998 and the Internet Bubble of 2000, to name but a few.

The value of a currency, like that of common stock, is a function of confidence in the return that you're going to get from a country or a company.

Investment speculation tends to originate in the economic environment prevailing at a particular time. But by their nature, their all-pervasive scope and their effect on all participants they can have an effect on sentiment, consumption and investment – and therefore entire economies – that often blurs the distinction between cause and effect. Of little dispute, however, is that there's a link.

Economics – and dislocations in the workings of particular economies – was the ultimate reason for the 1998 Asian crisis. However, the mechanism through which this manifest itself was through currencies and the currency markets.

In SA we currently face another potential economic crisis, this time one of our own making; but again, one in which policy mishaps and economic dislocation result in a currency trading at an inappropriately high level. This is now having an effect on investment in our market and is therefore worth commenting on. We have drawn an analogy between currency and stocks, so as to highlight the causal link.

Currency matters

Recent rand strength has played havoc with SA's economic fundamentals. The immediate prospects for our economy are no longer as favourable as they appeared only three months ago. Events taking place in offshore markets have on a number of previous occasions had a direct, and detrimental, effect upon our market and economy. Unfortunately, this is part of SA becoming more integrated into the global financial village.

Therefore we'll find that we need to better understand how our fortunes may be tied to those of other countries. Interest rates in developed markets are falling faster, or are at significantly lower levels, than currently exist in SA. As a result, money has flowed into the rand to benefit from a higher real return. This phenomenon has been helped by a weaker US dollar, itself the consequence of deteriorating US economic fundamentals.

A strong rand has made exports less competitive worldwide. Profits have disappeared as margins have contracted and imports have gained market share at the expense of SA producers. The current account and trade balance has therefore deteriorated.

To better understand what's at issue it may make sense to explore currencies, what they represent and how, in theory, they should be valued.

A currency is a country's medium of exchange with the outside world. Its value, relative to another currency, depends ultimately on the value of goods and services that the country provides. It is, if you like, a share in a country.

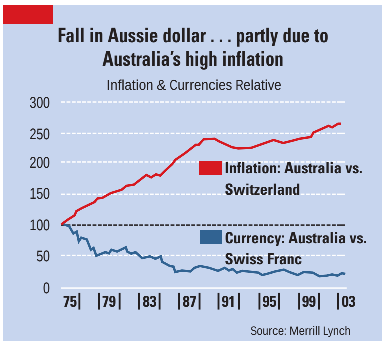
Over the very long term, currency movements tend to reflect inflation rate differentials between countries.

It's the means through which to participate in that country's economy and, like stock, it pays a dividend – a variable dividend, which is the interest rate available on that currency.

Over the very long term currencies tend to move to maintain what's called purchasing power parity. This means that if US$1 buys a loaf of bread in the US, if you convert that $1 into euros you'll be able to buy approximately a loaf of bread in France; and if you convert a dollar into rand you should be able to buy approximately a loaf of bread in Johannesburg. It might be less/more than a loaf, but it shouldn't differ by a vast magnitude.

There can be very large temporary divergences, but over the long term these prices and relative values tend to move together. That's to say, over the very long term, currency movements tend to reflect inflation rate differentials between countries.

In the charts below US brokerage house Merrill Lynch tries to demonstrate how currencies, inflation rates and growth rates are closely linked.



Over the short term, other factors – such as capital flows, monetary and fiscal policy, interest rates, political risk and such like – can affect relative currency values quite substantially.

The table below draws on the analogy between a currency and a common stock.

Company Equity Analogy

COMMON STOCK	CURRENCY
Management	Politics
Supply of stock to market	Money supply
Balance Sheet	External debt
Cash flow statement	Trade accounts
Dividend	Interest rate
Real return on capital	Real interest rate

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The value of a currency, like that of common stock, is a function of confidence in the return that you're going to get from a country or a company. In a company's case, confidence in management is important. A country's political environment, political stability, the quality of its politicians, the government (and its policies) and how effective they are all affect perceptions about a country and, therefore, affect the value of its currency.

It's more likely that stable countries will find favour ahead of those that are less so: a reason why the US dollar, Swiss franc, euro or Japanese yen tend to be favoured reserve currencies ahead of the Zimbabwean dollar, Brazilian real, Turkish lira or Argentinean peso.

The yield (interest rate) you receive in a foreign currency will exactly compensate you for the fact that it's going to fall in value by the inflation or interest rate differential.

One of a number of things that affects the price of shares is whether there's going to be a new share issue. The thing that corresponds closest to this, in the case of currency, is money supply, because it determines the availability of the asset that you own.

Investors are also concerned with balance sheet-type considerations. With a share you look at the balance sheet to see how financially sound the company is. With a currency you look at the level of the country's external debt to see whether the country can meet its obligations and if it will be able to in the future.

There are sometimes sound companies that have cash flow problems, and that's why one analyses the cash flow statement. In the case of a country, and therefore its currency, the thing that roughly corresponds to this is the trade account – a record of how much it's importing and the excess of that over what's exported, which gives you an indication of whether the country has embarked upon an economic course that it can sustain or whether it's going to have to implement policy changes in the future. Policy changes will affect the other factors that are important, like inflation and interest rates.

The dividend is also important. In the same way that someone holding a foreign currency would value the prevailing rate of interest, when you analyse a stock you look at the real return on capital, or how well management is investing the money that you've entrusted to it. When you look at a foreign currency deposit you tend to focus on the real interest rate, what your return is going to be over the country's expected inflation rate.

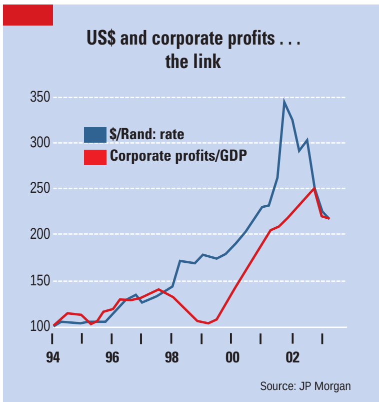
Interest rates vary in different countries, and a way to analyse this is to think of the interest as being compensation for the risk of owning that country's currency. If you take an extreme example, an investor thinking of owning the Russian rouble – which you know is likely to devalue because of Russia's high inflation rate – could demand a high interest rate to compensate against that risk. Not surprisingly, rouble interest rates are now extremely high.

However, if you're looking at a currency to invest in like the US dollar, where inflation is very low, you'll see that it's been a safe and stable haven of value and historically has tended to appreciate against most currencies. Therefore, you'd accept a much lower interest rate. So it's not entirely surprising that US interest rates are relatively low.

The higher the risk that the market perceives in a currency the bigger the yield premium it demands for investing in that currency. Investors require adequate compensation for holding potentially risky currency.

In theory, the yield (interest rate) you receive in a foreign currency will exactly compensate you for the fact that it's going to fall in value by the inflation or interest rate differential. So the bad news would be that the currency has fallen in value; the good news that you have more of it.

SA currently has high real interest rates. However, the rand is strengthening as yield searchers take advantage of high real returns and buy more rand. This in turn further strengthens their rand return. This virtuous circle will eventually turn vicious as the strong rand shifts SA growth, the SA Reserve Bank reacts and interest rates collapse, making rand real returns less attractive and holding rand less interesting.



JP Morgan's chart demonstrates a close historic correlation between corporate profit; the US dollar/rand exchange rate and, eventually, GDP.

To summarise, a currency can be regarded as the common stock of a country. The expected real return and the safety of that return determine its value. Currencies move independently of stock or bond markets. However, for a foreign investor they're a factor in the performance of both these asset classes, but they're an independent variable.

The higher the risk that the market perceives in a currency the bigger the yield premium it demands.

The movement of currencies may add to, or detract from, an investment decision and, as such, they require a better understanding so as to quantify the risks associated with investing in particular markets. In certain situations understanding how markets and currencies are related can help better position investments for likely consequences.

The recent currency turmoil, and the effect this has had on SA's economy and markets, has proved that it's now all the more necessary to appreciate how different currency and currency variables may interrelate. It's also important to understand how economics has a role to play. This is just one way of determining the link between economics and investing. ■

The weakest link?

The economy and the stock market

BY WILLI JONKER
Interneuron

ONE would be inclined to think that the level of the stock market is closely linked to the performance of the economy. When asked about the prospects for the market, most commentators start off by discussing the state of SA's economy.

In reality, however, this link is quite obscure.

Newsletter guru Kurt Richebacher says that the US economy is short on theory and long on statistics. Let's first look at some US statistics relating to the performance of their market relative to their economy.

We can distinguish two 17-year periods: The first runs from 31 December 1964 to 31 December 1981. This period we will call the fat years. The US's gross national product increased by 377%.

The second, or lean, period runs from 31 December 1981 to 31 December 1998. US GNP grew by only 177% – less than 50% of the growth rate of the fat years.

What did the market do over these two periods? Look at the level of the Dow Jones industrial average:

- 31 December 1964: 874,12
- 31 December 1981: 875
- 31 December 1998: 9 181,43

The US market managed a total rise of 0,1% during the 17 fat years. And a 949,3% rise during the lean years!

SA's market displays the same apparent disregard for economic fundamentals. The all-share Index lost 2,5% in 2000 and gained 25,4% in 2001 – yet the SA economy grew slightly more in 2000 than in 2001.

Why is the link so weak? A more appropriate question would be: What, then, determines the level of the stock market? Clearly, the level of economic growth is not the main determinant. Share prices can be broken down into the following two components:

- The expected earnings stream (profits) to be produced by the share over the foreseeable future.
- Investors' judgement of how certain the earnings stream is, reflected by how many times the earnings they're prepared to pay for the share.

However, the gross domestic product calculation includes factors that don't produce earnings for companies. An increase in some factors, such as inventories (stock on hand), will reduce a company's profit but increase the country's GDP.

As an aside, the economic indicators we commonly use are not even a good indicator of a nation's wealth. In the US, the per capita gross national product in constant dollars grew by 50% during the Forties – the highest growth of any decade of the 1900/2000 century. Yet most of the "growth" represented items expended by the military during World War 2.

Don't act on the latest economic news – such actions may cost you money.

Should we ignore economics? No. There are some economic indicators that provide valuable clues to the likely direction of the market. The most relevant of these are money supply and interest rates – variables.

Central banks are legalised counterfeiters. They're allowed to create money from thin air. When a central bank wants to encourage economic activity it usually lowers the interest rates at which other banks may borrow from it. The purpose of this step is to encourage banks to lend more money to the public. The public is then supposed to invest and spend that money, and so boost the economy. Conversely, when central banks want to cool down the economy they raise interest rates.

While the theory is good it doesn't always work this way in practice. For example, not all the newly created money actually finds its way into the "real economy". It's easier to buy shares than to build factories. The first consequence of lower interest rates is thus usually higher share prices. Conversely, rising interest rates are bad for the market.

Incidentally, going back to the US, the level of the long-term government bond interest rate at the beginning and end of the fat and lean years was as follows:

- 31 December 1964: 4,20%
- 31 December 1981: 13,65%
- 31 December 1998: 5,09%

The best time to buy shares was in 1981, when interest rates were high. This spells trouble for the current scenario in the US, where long-term interest rates are around the 5% mark and short-term rates at their lowest level in more than 40 years.

Apart from the factors we have already mentioned, there are further reasons why there's a low correlation between the level of prices on the JSE Securities Exchange and SA's economy.

For starters, most of our large companies currently derive a substantial if not major portion of their earnings offshore. Think of Anglo American, BHP Billiton, Richemont, Anglo Platinum, Sasol, SABMiller, Old Mutual and AngloGold – the top eight, representing more than 50% by value of the all-share index. Not one of these companies will really do a lot better if the growth rate in SA's economy improves from, say, 2% to 3%. They have diversified their businesses away from SA's economy.

Ironically, if the economy does well and the rand strengthens as a result these companies' offshore earnings will be lower when translated into rand. One might thus argue that more than 50% of the JSE is negatively correlated with the fortunes of SA's economy.

This was borne out from September to December 2001, when the economy ran into problems as a result of the global slowdown. However, the rand weakened dramatically and the JSE all-share index rose by 48% in just three months. Conversely, in 2002 and early 2003 SA's economy surprised us on the upside – yet the market declined by 30% from peak to trough.

When the market goes down it's usually because people fear that it will go down – not because of the most current economic event that's pounced upon by commentators and journalists as the reason. Don't act on the latest economic news – such actions may cost you money. ■

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